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International Economic Impact of Increased Oil Prices in 1974

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INTERNATIONAL ECONOMIC IMPACT OF INCREASED OIL PRICES IN 1974

SUMMARY

Increased prices will mean a $70 billion increase in the Free World oil bill in 1974, if world oil exports approximate the 1973 level, as seems likely. Western Europe will experience about a $33 billion increase; Japan, $11 billion; and the United States, almost $16 billion. If the United States were to cut 1974 consumption by 5% of the 1973 level, the added import bill would be about $12 billion; a 10% cut would limit the increase to about $9 billion. Only a small part of these increases can be offset in the countries' current accounts by exports to the oil producers, transport receipts, and remittances of oil company profits. US trade competitiveness will tend to improve because the country depends less on imported oil than do Western Europe and Japan, but this advantage may be offset at least partly by the dollar's appreciation.

Soaring payments for oil threaten a massive loss of purchasing power in the importing countries, equivalent to about 3% of GNP in Western Europe and Japan. Unless expansionary measures are taken, all face severely reduced rates of economic growth – perhaps even declining output – and increased unemployment. The governments will be cautious in inflating demand, however, because of the already high rates of inflation and the uncertain impact of the energy supply constraint on productive capacity.

Any attempts to redress deteriorating trade balances – through import restraints or competitive devaluation – could aggravate international economic tensions. The energy problem has already shifted attention from international trade and monetary negotiations. In any event, major governments will be hesitant to move forward on reform issues until economic prospects become clearer.

The producing countries' oil revenues will reach about $95 billion in 1974 – three and a half times as much as last year. Receipts will rise by about $14 billion for Saudi Arabia; $14 billion for Iran; $8 billion for Venezuela; and about $5 billion each for Kuwait and Libya. The receipts of Saudi Arabia, Kuwait, and the other small Persian Gulf states will far exceed their spending capability.

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Note: Comments and queries regarding this publication are welcomed. They may be directed to [redacted] of the Office of Economic Research, [redacted]

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If the oil producers continue to follow conservative investment policies, world financial markets should be able to absorb their new wealth with little disturbance during 1974. The massive buildup of funds will be a potentially destabilizing force in world exchange and financial markets, however. The oil crisis has already affected exchange markets as witnessed by the strengthening of the dollar in Europe and the devaluation of the Japanese yen.

DISCUSSION

Introduction

1. This publication is an initial assessment of the possible impact of increased oil prices on the main consuming areas in 1974.* It also considers some implications of the price hikes for government policies. Discussion is based on the following three assumptions:

- The major exporters' oil prices will remain – on the average – at current levels throughout 1974.
- World oil exports in 1974 will approximate the estimated 1973 level of about 32 million barrels per day (b/d), even if the Arabs fail to increase output above the current level.
- Oil demand will be essentially unchanged from the 1973 level. Higher prices, conservation efforts, and the general economic slowdown will offset the 5% increase in demand that was expected before the crisis began.

2. These assumptions lead to only one of several possible scenarios for 1974. The trend in world oil consumption will depend on both the level of Arab oil output and the ability of consumers to reduce oil use without restricting production. If the Arabs move closer to pre-crisis production levels, as we believe they will, oil consumption will be higher than assumed even if prices are maintained or increased. This judgment rests on the belief that the oil importing countries would choose to allow their balance of payments to worsen in order to maintain economic growth and employment.

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* Petroleum production and consumption of the Communist countries are excluded from the analysis, but petroleum trade with the Free World is included. This trade is relatively small.

International Oil Prices

3. Oil prices are at unprecedented levels. Posted prices – on which producing countries' royalties and taxes are based –have jumped more than 300% since 1 January 1973. The posted price of a typical Persian Gulf crude, for example, is now US $11.65 a barrel (see Table 1), compared with $2.59 just one year ago. The average c.i.f. cost of imported crude oil in the United States during the same period increased from $3.60 to $10.50 per barrel. Although the great bulk of world oil trade takes place at prices derived from official posted prices, an increasing amount of government-owned oil arising from equity participation is being sold at even higher prices.

Table 1

Price Structure for Selected Crude Oils, 1 January 1974

US $ per Barrel

	Persian Gulf (Saudi Arabian) (34° Crude)	Nigerian (34° Crude)	Libyan (40° Crude)	Venezuelan (26° Crude)
Posted price[1]	11.65	14.69	15.77	13.67
Production cost	0.10	0.35	0.30	0.51
Government revenue	**7.01**	**8.73**	**9.49**	**8.59**
Of which:				
Royalty	1.46	1.84	1.97	2.28
Profit tax	5.55	6.88	7.42	6.31
Estimated oil company profits	0.50	0.50	0.50	0.50
Estimated sales price (f.o.b.)	**7.61**	**9.58**	**10.29**	**9.60**
Estimated transport cost[2] (to US Gulf Coast)	1.48	0.67	0.65	0.46
Estimated sales price (c.i.f.) (to US Gulf Coast)	**9.09**	**10.25**	**10.94**	**10.06**

1. Differences in posted prices reflect differences in oil quality and transport costs.
2. Transport costs are assumed to be about the same as the average for 1973 (i.e., Worldscale 100).

4. The increase in posted prices has sharply boosted producers' revenue per barrel. For example, government revenue for Saudi Arabian 34° crude has increased from $1.52 to $7.01 per barrel since 1 January 1973. Price increases for other countries, such as Nigeria, Libya, and Venezuela, have added about $7 a barrel to government oil revenues.

Impact on Consumer's Oil Import Bill

5. The consuming countries' oil import bill will increase dramatically in 1974. Higher prices will result in a phenomenal rise in the cost of world oil imports from about $45 billion in 1973 to $116 billion in 1974 (see Table 2).. In Western Europe and Japan, oil import bills will rise by roughly 160% to $56 billion and $18 billion respectively. We do not expect the West Europeans' and Japanese to implement conservation measures that would reduce their oil consumption materially this year. The US oil import bill is projected to grow by some 170% to $25 billion. The US bill could be reduced by $4 billion if consumption were held 5% below the 1973 level and by $7 billion with a 10% cut.

Table 2

Free World Countries: Value of Oil Imports

Billion US $ c.i.f.

	1973 Estimated	1974 Projected
Total	44.9	116.0
United States	9.3	25.0
Japan	6.6	18.0
Western Europe	22.2	55.5
Other	6.8	17.5

Impact on Oil Producer Revenues

6. The oil price increases will sharply boost the exporting countries' revenues in 1974 to about $95 billion, or 3-1/2 times the amount in 1973 (see Table 3). The Arab states will receive one-half of the total revenue increase. with Saudi Arabia showing the largest gain.

7. Most producers will be able to spend only a small part on foreign goods and services (see Table 4). Even before the recent price increases, the earnings of Saudi Arabia, Kuwait, and the other small Persian Gulf states exceeded their absorptive ability. Saudi imports of civilian and defense goods and Saudi aid disbursements to other Arab states probably will grow substantially in 1974, but by nowhere near the amount of the increase in earnings. Assuming $1 billion in Saudi grants to other Arab states and import growth of 20%, Riyadh would spend only about $3.5 billion of an estimated $20 billion in earnings. Even if the Saudis managed to increase imports by 50% and doubled their grants, the surplus of revenue over

Table 3

Free World Producer Revenues from Oil Exports

Billion US $

	1973 Estimated	1974 Projected
Total	27.0	94.7
Arab	15.1	50.6
Saudi Arabia	5.5	19.9
Kuwait	1.9	7.3
Libya	2.3	7.0
Algeria	1.0	3.4
Iraq	1.7	6.4
Other	2.7	6.6
Non-Arab	11.9	44.1
Iran	4.5	18.5
Indonesia	1.2	4.1
Nigeria	2.4	7.9
Venezuela	3.0	10.6
Other	0.8	3.0

Table 4

Oil Revenue and Current Account Expenditure of the Producing Countries

Billion US $

	Oil Revenue		Total Foreign Exchange Earnings		Imports, Grants, and Other Current Transfers		Current Account Balance	
	1973 Estimated	1974 Projected	1973 Estimated	1974 Projected	1973 Estimated	1974 Projected	1973 Estimated	1974 Projected
Total	27.0	94.7	30.2	97.6	22.4	30.2	7.8	67.4
Arab	15.1	50.6	15.9	51.8	8.8	11.5	7.1	40.3
Saudi Arabia	5.5	19.9	5.7	20.1	3.2	3.5	2.5	16.6
Kuwait	1.9	7.3	2.1	7.6	1.0	1.6	1.1	6.0
Libya	2.3	7.0	2.3	7.0	1.3	1.7	1.0	5.3
Algeria	1.0	3.4	1.4	3.9	1.4	1.8	....	2.1
Iraq	1.7	6.4	1.7	6.5	0.8	1.0	0.9	5.5
Other	2.7	6.6	2.7	6.7	1.1	1.9	1.6	4.8
Non-Arab	11.9	44.1	14.3	45.8	13.6	18.7	0.7	27.1
Iran	4.5	18.5	5.0	19.0	4.7	5.9	0.3	13.1
Indonesia	1.2	4.1	2.1	4.2	1.8	2.3	0.3	1.9
Nigeria	2.4	7.9	3.2	8.7	3.2	4.0	....	4.7
Venezuela	3.0	10.6	3.2	10.9	3.1	4.0	0.1	6.9
Other	0.8	3.0	0.8	3.0	0.8	2.5	....	0.5

expenditure still would be some $15 billion. Since Kuwait and the small Persian Gulf states have even greater per capita oil revenue than Saudi Arabia and fewer domestic investment opportunities, they will necessarily also run relatively large current account surpluses in 1974.

8. Other Arab producers have a greater current need for oil earnings to finance their economic development and military programs, but even in these countries the magnitude of the revenue increase and the normal delays in planning and decisionmaking make it virtually impossible to spend all revenue this year. A rise in total imports of 25% in 1974 would leave the other Arab producers with an aggregate current account surplus of some $13 billion. Even if these countries undertook to finance the development of poorer Arab states, such as Egypt, the short-run impact would probably be slight. Beyond 1974, however, expenditures might gradually approach income if there were no further oil price rises.

9. The major non-Arab oil exporters -- Iran, Indonesia, Nigeria, and Venezuela -- will find it somewhat easier to expand imports. For the most part, these countries have larger populations, more experienced governments, and greater opportunity for economic diversification than do the Arab producers. Nevertheless, the revenue increases are bound in the short run to outstrip the ability even of these countries to absorb foreign goods and services. If imports grow by 25% during 1974 -- the average rate in recent years in fast growing Iran -- these countries will run a combined current account surplus of $27 billion.

Impact on Consumers' Current Accounts

10. Consuming countries' current accounts will be significantly worsened in 1974 by the dramatic increase in oil import bills. Substantial deficits on oil trade will be only partially offset by a return flow of transport receipts, company profits, and export earnings. The resulting current account deficits raise major questions about the adequacy of aggregate demand in consuming countries and the future efficacy of the international financial system.

11. The United States traditionally has had a comparatively more favorable oil-related current account than have other consumers, and there will be factors tending to continue this advantage in 1974. Although the US share of the world's oil import bill will be only about 22%, it is assumed that:

- American companies will continue to receive about 60% of international oil profits [redacted] compared with 30% for West European companies and 5% for Japanese companies. 25X1

- The United States will maintain its approximately 20% market share of oil producing countries' imports.

- The United States will receive net receipts from various transport account transactions associated with the international oil trade that are sufficient to offset essentially the transport costs of imported oil.

The United States, nevertheless, is expected to have an oil-related current account deficit of $13.7 billion in 1974 [redacted] surplus in 1973 [redacted] 25X1

12. The oil-related current accounts of the two other principal consuming areas, Western Europe and Japan, will also be in substantial deficit in 1974 because of the inability of oil producers to spend much of their sharply higher earnings on European and Japanese goods. In the case of Western Europe, the oil-related current account deficit is estimated to increase from $5 billion in 1973 to a phenomenal $35 billion in 1974; in the case of Japan, the deficit will grow from $3 billion in 1973 to $14 billion in 1974.

13. Offsetting the consumers' oil-related current account deficits will be a substantial capital inflow from the oil producers. For the three principal consuming areas combined, the return capital flow probably will exceed their current account deficits. This will occur because the net monetary balance transferred to the oil producers – including the amount transferred by the less developed countries that must import oil – will be kept largely in the advanced countries' well developed money markets. The funds, of course, will not flow back to the countries in the same proportions as their shares of the world oil import bill.

14. The overall impact of increased oil prices on the consuming countries' trade and current accounts will depend not only on the oil import bill and the oil-related current account but also upon the indirect impact on other flows. US international competitiveness probably will tend to be enhanced because the United States relies less on imported oil than do other major consumers. However, this very strength and the oil producers' preference for dollar assets probably will result in a further appreciation of the dollar.

Impact on Growth

15. The projected deterioration of $54 billion in the oil-related current accounts of the principal consuming countries in 1974 represents a substantial loss of purchasing power and will depress demand and slow growth, except to the extent offset by corrective action. In the absence of increased private investment, increased government spending, or reduced taxes, purchases of goods and services other than petroleum will have to be cut. Because of the multiplier process, the initial $54 billion leakage in demand would result in a much greater overall loss in income. Although individual countries can lessen the deflationary impact on their economy by improving their trade account, it is, of course, not possible for all countries to do so.

16. The deflationary impact of the oil price rise will vary among consuming areas. Western Europe and Japan will be the hardest hit; the direct loss in purchasing power will amount to about 3% of GNP and some 8% to 10% of fixed investment in these areas. In the United States, the direct loss in purchasing power will equal only about 1% of GNP and 4% of fixed investment.

17. It is unlikely that increased investment could substantially offset the deflationary impact of higher oil prices. Even though the massive increase in the supply of loanable funds in world money markets arising from the oil producers' current account surpluses will put downward pressure on real interest rates, the oil crisis will have a generally negative impact on investor confidence. This will at least partly counter the stimulative effect of reduced interest rates.

18. The fiscal stimulant required in 1974 to offset the increase in the cost of oil imports and thereby avoid a substantial slowdown in economic growth, if not a decline in real output, amounts to some $10 billion in Japan and $30 billion in Western Europe. At the same time, the governments face an unusually severe problem of inflation -- largely of the cost-push variety -- which has itself been worsened by the oil crisis. Western governments will be reluctant to aggravate inflation by undertaking large-scale expansionary programs, at least until the severity of the impact on output and employment becomes apparent. Any lag in implementing expansionary policies will make a downturn more severe.

19. For the moment Japanese demand management policies continue to be directed more at controlling inflation than at stimulating demand. Because of supply shortages at home and higher import prices, the Japanese wholesale price index in December was about 25% above the previous year's level and inflation is expected to continue unabated in 1974. Tokyo will consequently move cautiously in taking any expansionary action, even if real output slows faster than necessary to bring energy supply and demand into balance. Concern over the trade balance, which probably will shift to a deficit this year, will also influence government policy. Tokyo would prefer to make up any deflationary gap by further lowering the yen's exchange rate and boosting exports than through increased government spending.

20. West European governments have similarly not yet focused on the deflationary impact of increased oil prices. Most governments are more concerned about the inflationary effects of higher energy costs, the balance-of-payments impact of the rising oil import bill, and the erosion in competitive position relative to countries less dependent on imported energy than they are about the leakage in purchasing power. These concerns probably will limit Western Europe's willingness to counter a future decline in demand through expansionary policies and will encourage attempts to shift some of the deflationary impact through parity changes. Bonn, which is reasonably sanguine about its short-term ability to cope with a higher oil bill because of its huge reserves, sees the recent strengthening of the dollar as beneficial. A substantial worsening of the balance of payments will make Italy, France, and the United Kingdom more eager to pursue beggar-thy-neighbor policies rather than stimulate domestic demand. Moreover, differences in dependence on energy imports and in the attractiveness of their currencies raise the possibility of competitive devaluations even among West European nations.

21. The dislocations caused directly by higher energy costs will have a serious negative impact on output and employment even if governments stimulate demand. Higher oil costs will require changes both in the production process and in the output mix. These changes will take time and will be disruptive in terms of inflation and employment. The necessary investment outlays may be slow in coming because of business uncertainty.

Impact on Trade and Monetary Negotiations

22. The deteriorating payments position of the major industrial nations and the growing financial strength of the oil producers should provide added incentive for progress in international trade and monetary negotiations, but the oil crisis has diverted attention away from these negotiations. Rather than seeking ways to head off the possibility of competitive depreciations, other beggar-thy-neighbor policies, or Arab manipulation of currency and capital markets, major governments have become more hesitant about moving forward on reform until economic prospects become clearer.

23. The sharp deterioration in their trade and current accounts that will result from the oil price rise will make the West Europeans and Japanese less willing than before to liberalize imports. This attitude will impede negotiations, which in any case have shown little progress. Protectionist pressures from business and labor as profits fall and unemployment increases could grow substantially. Pressure will mount to shift a portion of the payments deficit and resulting deflation to other countries by increasing exports and reducing non-oil imports.

24. Progress in the monetary negotiations – slow even before the energy crisis erupted – may well cease for a time. The impetus existing for reform in early 1973 began to lose steam with the improvement in the US trade position and the accompanying strengthening of the dollar. Now, with the uncertainties created by the oil situation, foreign capitals are unlikely to seek an agreement that would fix exchange rates.

Impact on Capital Markets

25. World financial markets should be capable of absorbing the oil producers' new wealth this year with only moderate adjustment. The oil producers have traditionally followed conservative investment policies, and the are likely to continue to do so in the near future. Their foreign holdings consist mostly of short-maturity interest-bearing assets -- generally dollar-denominated – and of dollar accounts, primarily in Western Europe. The producers' new riches probably will depress real interest rates, particularly on short-term dollar assets, and could create some intermediation problems between short- and long-term assets if insufficient short-term assets are available.

Impact on Exchange Rates

26. The oil crisis has already affected world exchange markets. The dollar's recent strength in Western Europe and the devaluation of the Japanese yen are, in part, attributable to the increase in oil prices. Moreover,

the massive buildup of funds by the oil producers will be a continuing potentially destabilizing force in world exchange markets. The producers' current account surpluses will total about $67 billion during 1974, of which about $40 billion will accrue to the Arab states. The choices as to the form of holding these assets made by the oil producers could have a substantial impact on currency values.

27. If oil producers continue to favor dollar assets, the increased demand for dollars could lead to a further substantial appreciation. Although this may not have an immediate impact on the US trade account, in the longer term it is likely to slow the growth of US exports and increase US imports. Thus, some of the deflationary problem overseas could be shifted to the United States.